COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

NOTICE OF CONTINENTAL TELEPHONE COMPANY OF KENTUCKY OF AN ADJUSTMENT IN ITS INTRASTATE RATES	)	CASE NO. 8182

ORDER ON REMAND

On September 24, 1982, the Franklin Circuit Court issued a final judgment in the appeal of Continental Telephone Company of Kentucky ("Continental") against the Public Service Commission ("PSC"). It set aside the PSC's attribution of toll settlement revenues and the computation of the Job Development Investment Credit ("JDIC"). It remanded to the PSC the issue of rate of return and ordered the PSC to make specific findings of fact pertinent to the reasonableness of the rate of return granted.

The PSC and the Attorney General's Office appealed the Circuit Court's order to the Court of Appeals on two points -- toll settlement and JDIC. The rate of return portion of the order was not appealed. It is that issue, which having been remanded to the PSC, is the subject of this order.

Cost of Capital

In its determination of an appropriate rate of return on equity, the Commission evaluated the methods proposed by the

Company's witness, Dr. Moul, and the witness for the Attorney General, Dr. Legler.

Dr. Moul recommends allowing a return on equity of 16 to 17 percent. This is based on an evaluation of the results of three widely accepted methods of approximating a reasonable return on equity: earnings to market price and earnings to net proceeds ratios; the capital asset pricing model ("CAPM"); and the discounted cash flow method.

Using the earnings to net proceeds ratios, Dr. Moul calculated a range of 10.3 percent to 12.8 percent for Continental Telephone Company ("CTC"), the parent of Continental Telephone of Kentucky, and a ratio ranging from 10.3 percent to 14.5 percent for other telephone companies. His historic earnings to market price ratios ranged from 11.9 percent to 14.8 percent for CTC and 11.8 perent to 16.2 percent for other telephone companies. However, he testified that these ratios only indicate a partial cost rate.

Although Dr. Moul presented testimony on the CAPM or risk premium method, the Commission is not convinced in this case, as it was not in Cases 8045, General Telephone of Kentucky, and 7790, Continental Telephone of Kentucky, that relying on debt cost at a particular point in time is a valid basis for establishing the cost of equity of a regulated company. The Commission's position on this method has been and continues to be that because of the changing patterns in the bond market, which tend to indicate that the cost of equity will not necessarily exceed the cost of debt at every point in time, there must be a longer term of analysis of appropriate bond issues to compensate for temporary abnormalities within a given period. Furthermore, cost of debt is but one element to be considered in ratemaking and is by no means the only measure of a fair rate of return.

The problems with this method are highlighted by Dr. Legler's proposal to modify the risk premium method to make it conform to certain market conditions. This, again, is indicative of the lack of certainty and credibility that currently clouds the reliability of the method.

Dr. Moul's final return calculation using the DCF method is 14.9 percent for CTC and 14.4 to 15.9 percent for other telephone companies.

Dr. Legler recommends an overall cost of capital of 13.35 to 14.78 percent. Using the DCF method, which gives a range of 14.1 to 15.2 percent, a risk premium analysis, which gives a range of 14.1 to 16.2 percent and a comparable earnings method, which gives a range of 14 to 15 percent, he computed the cost of equity to CTC to be 14 to 16 percent.

Eliminating the risk premium estimates, the methods used by each witness produce estimates of CTC's cost of equity in the range of 14 to 15 percent -- Moul's DCF is 14.9 percent, Legler's is 14.1 to 15.2 percent, with Legler's comparable earnings being 14 to 15 percent.

The remaining difference between Dr. Legler's final recommendation and Dr. Moul's is Legler's use of a double leverage adjustment. The primary reason for making this adjustment is to recognize the benefits Continental receives from the use of capital of its parent at a lower cost than the return it receives on the use of that capital.

Because of the facts of this case, it is unnecessary for the Commission to apply, or reject for that matter, the double leverage adjustment. The difference in capital structures between CTC and Continental provides the basis for adjusting Continental's rate of return slightly downward to compensate for the less risky capital structure of Continental in relation to CTC's capital structure. The CTC consolidated capital structure at the end of the test year had a common equity ratio of 34.38 percent, while Continental had a ratio of 40.11 percent. It is the Commission's position that the lower debt ratio of Continental places it in a less risky position because of its ability to generate a larger portion of its financial needs outside of the debt market. For this reason, a range of 13.5 to 14.5 percent rate of return on equity is reasonable. The range is consistent with the testimony of both witnesses, but reflects the slightly lower risk to Continental because of its capital structure. The rate allowed Continental is 14.25 percent, which is near the top end of this range. This rate will allow Continental to achieve a fair, reasonable rate of return, attract capital and maintain its financial integrity.

Authorized Increase

The additional revenue required, based on the rate of return found reasonable is $1,091,605, computed as follows:

Adjusted Net Operating Income	$4,824,154 1/
Net Operating Income Found Reasonable	5,376,995
Deficiency	552,841
Deficiency Adjusted for Taxes and Uncollectables, or Increase	$1,091,605 2/

The Commission, based on the above findings, ORDERS that the rates found fair, just and reasonable as set forth in Appendix A of the Commission's Order of September 21, 1981, are affirmed.

Done at Frankfort, Kentucky, this 25th day of January, 1983.

PUBLIC SERVICE COMMISSION

Chairman

Vice Chairman

Commissioner

ATTEST:

Secretary

1/ Includes Interest During Construction of $17,000.

2/ (552,841 ÷ .5076 ÷ .99773 = $1,091,605.